APPENDIX

SUPPLEMENTAL APPENDIX

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 02-56989
D.C. No. CV-98-01537-L/CGA
Southern District of California, San Diego

In re: DAOU SYSTEMS, INC., SECURITIES LITIGATION,

GREG SPARLING; EUGENE KRABBENHOFT; PATRICK DE KRUYFF, ESQ.; ROBERT ZARETSKY; ROD FORD; THOMAS V. HAGMAN; RICHARD W. WALSH; RICHARD TORIBIO; PAUL RABIN,

Plaintiff-Appellants,

v.

GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL; JOHN MORAGNE; DAOU SYSTEMS, INC.,

Defendants-Appellees.

ORDER

(filed March 3, 2005)

Before: B. FLETCHER, PREGERSON, and BRUNETTI, *Circuit Judges*.

Consideration of the petition for panel rehearing filed by Daou Systems Inc., et al., is deferred pending the Supreme Court's decision in *Dura Pharmaceuticals. Inc. v. Broudo*. Supreme Court Docket No. 03-932.

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Plaintiff-Appellants,

v.

GEORGES DAOU; DANIEL DAOU; FRED MCGEE; ROBERT MCNEILL; JOHN MORAGNE; DAOU SYSTEMS, INC.,

Defendants-Appellees.

ORDER

(filed April 20, 2005)

Before: B. FLETCHER, PREGERSON, and BRUNETTI, *Circuit Judges.*

The parties are directed to file, within 21 days of this order, simultaneous briefs not to exceed fifteen (15) pages addressing the impact of the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo,* 544 U.S. (2005), on the opinion in this case.

Supreme Court, U.S.
FILED
JAN 12 2006
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No. 05-700

IN THE

Supreme Court of the United States

DAOU SYSTEMS, INC., GEORGES DAOU, DANIEL DAOU, FRED MCGEE, ROBERT MCNEILL AND JOHN MORAGNE,

Petitioners,

v.

GREG SPARLING, EUGENE KRABBENHOFT, PATRICK DE KRUYFF, ROBERT ZARETSKY, ROD FORD, THOMAS V. HAGMAN, RICHARD W. WALSH, RICHARD TORIBIO AND PAUL RABIN, ON BEHALF OF THEMSELVES AND ALL OTHERS SIMILARLY SITUATED,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR THE PETITIONERS

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CORPORATE DISCLOSURE STATEMENT

On October 28, 2005, Daou Systems, Inc. merged with PRX Acquisitions Sub, Inc. to form Proxicom-Daou, Inc. Proxicom-Daou, Inc. is wholly owned by Proxicom, Inc. There is no publicly held corporation that owns 10% or more of stock in Proxicom, Inc.

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REPLY BRIEF FOR THE PETITIONERS

I. THE NINTH CIRCUIT OPINION HERE, IN THE IMMEDIATE WAKE OF THIS COURT'S DECISION IN *DURA*, UNDULY LIMITS THE HOLDING IN *DURA*.

The opposition to the petition for a writ of certiorari is most significant for what it does not address—*that the Ninth Circuit's opinion below diverges, significantly, from the decisions of other courts that have considered this Court's decision in Dura Pharmaceuticals, Inc.* v. *Broudo*, 125 S.Ct. 1627 (2005). *See* Pet. 11-14. Respondents simply ignore this conflict that is obvious to others. Indeed, comparing the

Ninth Circuit's decision here with the Sixth Circuit's decision in *D.E. & J. Limited Partnership* v. *Conaway*, Nos. 03-2334, 03-2417, 2005 WL 1386448 (6th Cir. Jun. 10, 2005), a recent Practising Law Institute article commented "[i]t is difficult to reconcile the holdings of the two appellate courts, which appear to have different concepts of what constitutes a disclosure of the 'relevant truth.'" Lyle Roberts & Paul Chalmers, *Shining a Light or Cursing the Darkness?—The Impact of Dura Pharms., Inc. v. Broudo*, in SEC. LITIG. ENFORCEMENT INST. 2005, at 343, 352 (PLI CORP. LAW & PRACTICE, COURSE HANDBOOK SERIES NO. 1505, 2005); *see also* Pet. 11 n.5 (citing other authority recognizing a post-*Dura* conflict).

In fact, a number of other courts of appeals and district courts that have considered the loss causation requirement, both pre- and post-*Dura*, are true to *Dura*'s holding: in order to plead loss causation, a plaintiff must causally link a drop in the stock price to a time at which an alleged fraudulent misrepresentation was discovered and the truth became known. *See* Pet. 11-14. By contrast, respondents contend that *Dura* is satisfied by an allegation that the stock price decreased, and that a plaintiff need not link that decrease to any point in time when the truth became known.

These are vastly different readings of the loss causation requirement and of this Court's decision in *Dura*. The literal language of this Court's decision in *Dura* found the complaint insufficient because it contained no allegation that there was a point in time when "the share price fell significantly after the truth became known." *Dura*, 125 S. Ct. at 1634. The cases cited in *Dura* rejected a holding that the issuance of a negative earnings report is sufficient to establish a moment when the truth became known. *See id.* at 1633 (citing cases); Pet. 9-12. This Court also justified its decision in *Dura* in part on the fact that there are manifold reasons why stock prices rise and fall. *See Dura*, 125 S. Ct.

at 1632. All of the above supports rejection of the Ninth Circuit's view of the loss causation requirement.

In the past, this Court has repeatedly granted certiorari to review court of appeals decisions that would have otherwise undone Congress's work in passing the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 109 Stat. 737. It should do so again here, particularly because the Ninth Circuit's decision threatens to undo much of what this Court accomplished in *Dura*. That is because the Ninth Circuit's interpretation of this Court's opinion in *Dura* more closely follows the Ninth Circuit's own *Dura* opinion, than this Court's opinion reversing it.

II. THE PRACTICE OF PLEADING THE FACTS OF A SECURITIES FRAUD CLASS ACTION USING "CONFIDENTIAL WITNESSES" MERITS REVIEW BY THIS COURT.

The second issue presented in the petition also merits review—the use of "confidential witnesses" in private securities fraud class actions in order to plead allegations relating to scienter, or allegations of misrepresentations or omissions made on information and belief." There is no mystery what is going on here. For many years, plaintiffs in securities fraud class action suits would plead the entire complaint "on information and belief." The holdings of several federal courts, as well as Congress's passage of the PSLRA, put a stop to this practice. Such facts must now be pled with particularity. *See* 15 U.S.C. § 78u-4(b)(1) and (2). Plaintiffs' counsel, however, have simply changed tactics by claiming that much, if not all, of their factual allegations come from "confidential witnesses."

While the protection of confidential witnesses may have a place in criminal law, it is hard to justify a similar role in civil action under the PSLRA. The identity of witnesses cannot be protected any longer than the first wave of written discovery. Therefore, the use of confidential witnesses could

serve no purpose other than to allow plaintiffs to survive the pleadings stage and reach the first wave of discovery, in the hopes of discovering facts that will allow the complaint to survive long enough to negotiate a lucrative settlement. Yet, that goal is entirely contrary to Congress's key goal in adopting the PSLRA, which is to impose a rigid gatekeeping function on securities fraud class action complaints at the pleadings stage. *See generally Dura*, 125 S. Ct. at 1634 (citing H.R. Rep. No. 104-369 at 31 (1995) (Conf. Rep.)).

This Court has never ruled on the propriety of using confidential witness allegations as a means of satisfying the PSLRA. Many district courts have held that the practice is not permitted. *See* Pet. 27-28. As is plain from the petition and the opposition, the practice will continue unless and until this Court brings it to a halt, and petitioners urge this Court to do so.

However, even if this Court concludes that the use of confidential witnesses to support certain allegations in a securities fraud class action is not *per se* impermissible under the PSLRA, one fact remains clear—there is a significant difference in the standards courts of appeals have applied to determine the sufficiency of allegations by confidential witnesses. *See* Pet. 19-26. Commentators have noted that the Ninth Circuit's approach below is more lenient. *See* Pet. 23 (citing authority). And, as exemplified by the different approaches followed by the district court and the Ninth Circuit in this case, the standard that is applied is determinative of whether a complaint is deemed sufficient under the stringent pleading requirements of the PSLRA, or whether it is dismissed. If allegations under the PSLRA may be based on confidential witness statements at all, this Court should clarify that there are strict limits on a complaint's reliance on such statements. This should include a rejection of the Ninth Circuit's lenient standard and the adoption of a requirement of close scrutiny of the allegations to establish the potential reliability of such witnesses.

CONCLUSION

For the foregoing reasons and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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